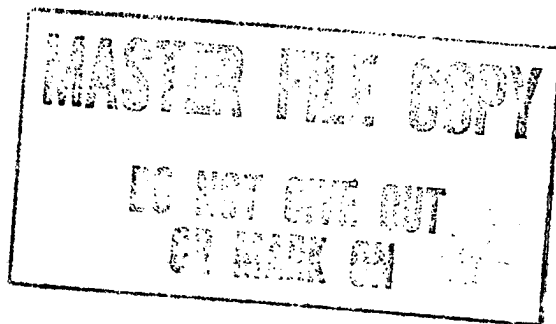




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## **The Hong Kong Talks: Possible Outcomes**

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**An Intelligence Assessment**

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March 1984*

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# **The Hong Kong Talks: Possible Outcomes**

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**An Intelligence Assessment**

This paper was prepared by [ ] Office  
of East Asian Analysis. Comments and queries are  
welcome and may be directed to the Chief, China  
Division, OEA, [ ]

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**The Hong Kong Talks:  
Possible Outcomes**

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**Key Judgments**

*Information available  
as of 15 February 1984  
was used in this report.*

After a year or more of fruitless talks, the British and Chinese have finally begun discussing the practical problems of transferring authority over Hong Kong from Great Britain to China. The British have conditionally conceded sovereignty—subject to Parliamentary approval—and even dropped their insistence on retaining a formal role in Hong Kong's post-1997 administration. But London still hopes to gain an unofficial advisory role and to conclude a treaty that will ensure that Beijing lives up to its promises to keep Hong Kong's socioeconomic system intact. Much hard bargaining remains.

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Both the British and Chinese have important incentives for reaching an amicable settlement. Beijing wants to:

- Inherit Hong Kong as a going economic concern to assist China's modernization.
- Rectify a deeply resented historical grievance at minimum cost.
- Show its tolerance for Hong Kong's capitalist system to induce Taiwan to engage in reunification talks.
- Demonstrate progress toward reunifying the country.
- Prevent problems over Hong Kong from discouraging Western investment in China.

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The British in turn recognize that a Chinese takeover in 1997 is inevitable and that an orderly transition that maintains local confidence and avoids turmoil is desirable. London is anxious to reach an agreement that allows it to withdraw with honor, while protecting the interests of the roughly 5.5 million residents of Hong Kong. It also wants to protect Britain's political and economic relations with China, as well as with Hong Kong.

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As a result, we believe the chances are better than even that the British and the Chinese will reach an interim agreement in the next year or two. Such an accord would buy time for the two sides to negotiate the complex technical aspects of a comprehensive agreement, which the British Parliament must then ratify. The initial reaction in Hong Kong to such an interim agreement probably would be favorable.

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The talks, however, could drag on, or even break down. Under these circumstances, Hong Kong's economy would suffer. Emigration and capital flight would grow, perhaps dramatically, increasing the burden on Beijing and London to maintain Hong Kong's economy. Relations between the two also would become frayed, making it that much more difficult to overcome the obstacles to a settlement.

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In the most extreme and least likely case, a collapse of the talks could trigger unrest serious enough to provoke direct Chinese military intervention.

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Alternatively, the British could cave in to China's demands, or even declare their intention to pull out of Hong Kong well before 1997. Either action would set off shock waves in Hong Kong. Business confidence would plummet and emigration would increase sharply—leaving Beijing with serious economic problems to sort out, even if the British sought to help calm local fears.

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US interests would be best served by an interim accord. If the talks break down, severe strains in Sino-British relations could adversely affect China's attitude toward other Western states. The collapse of negotiations would also affect some US companies, which have an estimated \$3-4 billion invested in Hong Kong. The United States, along with other Western states, would also face the problem of how to deal with the potential flood of immigrants.

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## The Hong Kong Talks: Possible Outcomes

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The Sino-British talks over Hong Kong have only recently begun to make progress on substantive matters. The British initially refused to acknowledge Chinese sovereignty, hoping to retain a formal British role in Hong Kong after 1997. But under persistent Chinese pressure, London finally acceded conditionally last summer to China's demand that Chinese sovereignty over the colony be recognized. After Hong Kong's business community began to show signs of panic last fall, the British made further concessions. In October the British dropped their insistence on a formal British presence in Hong Kong after 1997 and indicated their willingness to negotiate on the basis of the Chinese plan for Hong Kong.

The Chinese initially doubted Prime Minister Thatcher's sincerity. This doubt strengthened after she publicly reiterated, in late October, London's interest in maintaining a link to Hong Kong after 1997. An unproductive session followed in November. British reassurances finally allowed the two sides to begin discussing substantive issues in December.

The British have prepared a series of briefing papers to "educate" the Chinese on Hong Kong's administration. These are now being used as a basis for discussions. Thus far, the Chinese have agreed to retain British expatriate administrators (although they could not agree at what level these officials should serve), maintain an independent judiciary, and implement a uniform land leasing system for Hong Kong.

### Incentives for a Settlement

Both sides have important political and economic reasons for reaching a mutually satisfactory settlement. As the eventual inheritor of Hong Kong, China has the most at stake. Beijing wants to keep Hong Kong's economy viable because of the important role the colony plays in China's modernization program. Not only does China earn about one-third of its foreign exchange in Hong Kong, but the colony is an important source of financial and technical assistance.

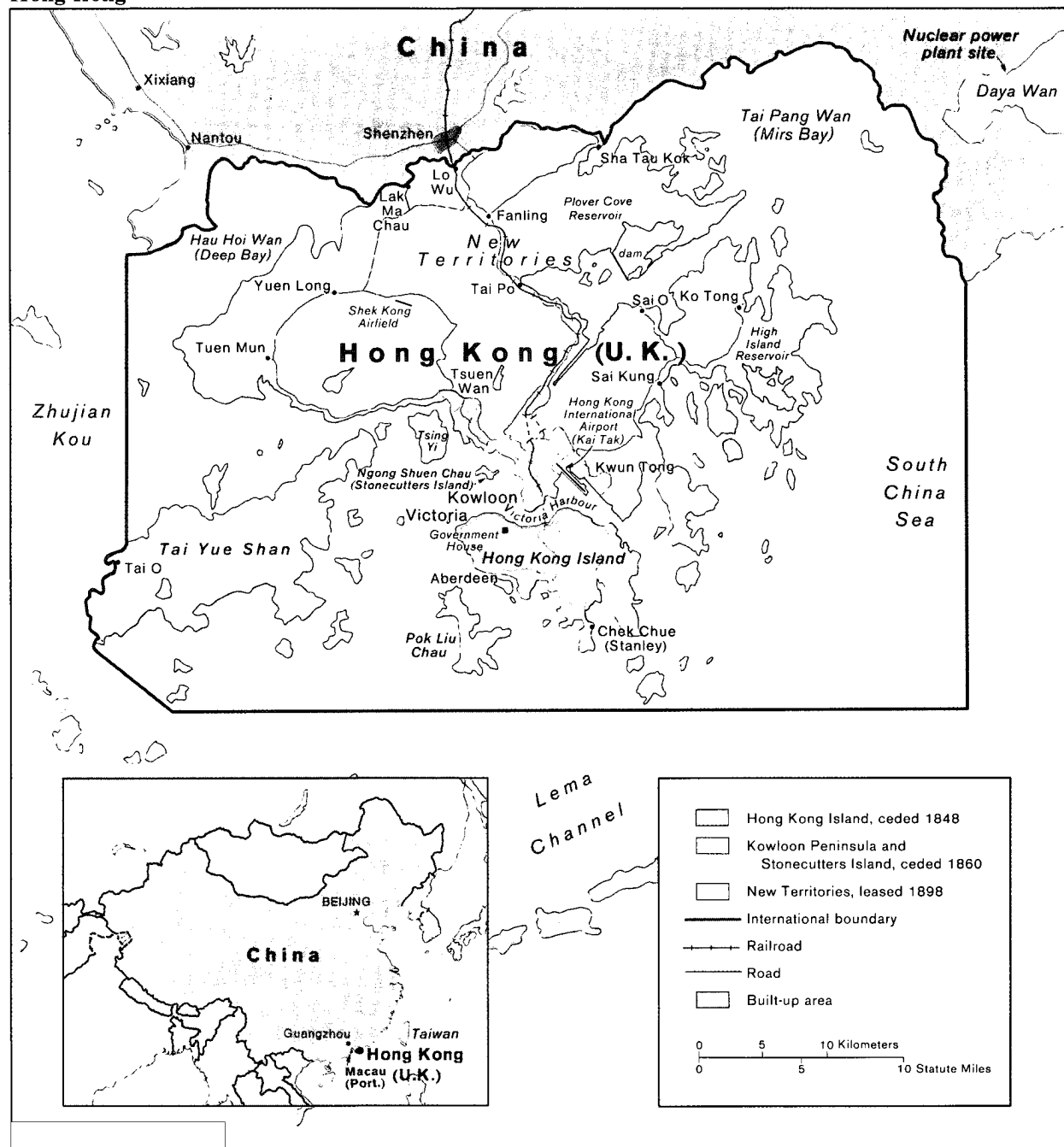
### Scope Note

*This assessment speculates on the directions the Sino-British talks on Hong Kong could take over the next few years. Six possible scenarios are offered along with the likely consequences for each. Although not intended as a precise estimate, the scenarios are presented in rough order of probability. In the introduction the background to the talks is discussed, including the incentives and prospects for a settlement. (C NF)*

*In developing these scenarios, we assume certain factors will remain constant: that no radical change in government will occur in either London or Beijing except where noted in the scenarios; that the international market for Hong Kong's exports will remain strong; that human and capital flight from Hong Kong will not reach serious proportions unless the talks turn sour. (C NF)*

Hong Kong business interests account for an estimated one-third to one-half of foreign investment in China and about 90 percent of the investments in the special economic zones. They are also important middlemen in China's trade with Western companies.

Beijing has gone to considerable lengths to reassure Hong Kong's business leaders and the rest of the population about China's intentions. Deng Xiaoping and other Chinese leaders have repeatedly promised to leave the city's social and economic system alone—for at least 50 years after 1997. Beijing also has intervened several times over the past year to prop up the Hong Kong dollar and has expanded its loans and investments in the city to demonstrate its commitment to the local economy's continued vitality.

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### **Beijing's Plan for Hong Kong**

*Chinese leaders have informally floated plans for Hong Kong in their media outlets in the colony and in meetings with Hong Kong residents to test local reactions. They have suggested these plans be codified in a so-called miniconstitution, which would be ratified by China's National People's Congress only after consultations with the residents of Hong Kong.*

[redacted]

*The highlights are:*

- *Hong Kong will become a special administrative region of China under Article 31 of the Chinese Constitution beginning in 1997 when Beijing regains sovereignty and administrative control.*
- *Hong Kong will enjoy a high degree of autonomy with local people administering the city. Beijing has raised the possibility of local elections to select the senior local authorities.*
- *Hong Kong's present capitalist social-economic system will remain unchanged for at least 50 years after 1997.*
- *Hong Kong's legal structure will remain basically unchanged except that the highest court of appeals will be in Hong Kong instead of London.*
- *Local and expatriate civil servants, including policemen and administrators can retain their jobs.*
- *Hong Kong's status as a free port and international financial center will remain unchanged.*
- *The Hong Kong dollar will remain a separate and freely convertible currency.*
- *Residents will enjoy the right of free speech, assembly, press, and the freedom to travel.*
- *Beijing will be responsible for Hong Kong's foreign affairs, but will maintain its separate status in international organizations and in international agreements. It will be allowed to issue its own travel documents.*
- *The Hong Kong government will be responsible for the public security, maintained by the local police force.*
- *The economic interests of Britain and other countries will be respected.* [redacted]

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Chinese leaders have similarly sought to reassure Japanese businessmen and other foreign investors that their interests will be protected. Beijing does not want

problems over Hong Kong to trigger a pullout of foreign companies, or to discourage foreign investment in China. [redacted]

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Finally, we believe the high priority Beijing attaches to promoting reunification with Taiwan has and will likely continue to influence its moderate and conciliatory approach. Chinese leaders hope Taipei will become more willing to negotiate if Beijing shows it can live with and even protect Hong Kong's capitalist system. [redacted]

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Balanced against these pragmatic considerations is China's determination—for nationalistic reasons—to regain Hong Kong. A key goal of the Communist revolution in 1949 was to expunge China's humiliation at the hands of outside powers. We believe the present Chinese leadership feels equally determined about completing that task by reuniting Hong Kong, Macau, and Taiwan with the motherland. Deng Xiaoping in fact has made reunification one of China's three major goals for this decade. Beijing probably is prepared, therefore, to pay a heavy economic price—if necessary—to regain Hong Kong by 1997. [redacted]

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Although the British have little confidence in China's ability to run Hong Kong, they recognize their negotiating leverage is limited and that a Chinese takeover is almost inevitable once the lease on the New Territories, which constitute about 90 percent of the colony, expires in 1997 (see map). Prime Minister Thatcher's main bargaining card is her ability to withhold the formal legitimacy a settlement would give China to recover sovereignty. [redacted]

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[redacted]

[redacted] British companies have concluded a number of major deals with China over the past few years

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including the Daya Bay nuclear plant to be built near Hong Kong. Overall bilateral trade between Britain and China was about \$600 million in 1983. [ ]

Nor does London want its economic stake in Hong Kong threatened by instability there. Although the United Kingdom accounts for only about 6 percent of direct total investment in the colony (as compared with 45 percent for the United States and 30 percent for Japan) Hong Kong replaced Japan in 1982 as Britain's largest Asian market. Trade between Britain and Hong Kong has grown from \$625 million in 1972 to \$2.4 billion in 1982. British firms have made sizable profits in the colony's service sector, especially in banking, real estate, and insurance. For certain British industries, such as shipbuilding, Hong Kong accounts for over half of all exports. [ ]

#### Prospects for Reaching a Resolution

In our judgment, therefore, the incentives on both sides for reaching at least an interim agreement within the next year or two are strong. Reaching an interim agreement will not be easy, however, and no agreement will eliminate the possibility of a serious decline in Hong Kong. To come to a settlement, London and Beijing will be required to reach some basic understandings on Hong Kong's future administration, including the role of British expatriates, and guarantees designed to ensure that China honors its commitments. [ ]

Guarantees may be particularly hard to work out. The Chinese will not accept any conditions that appear to infringe on their sovereign rights. Nevertheless, the British hope to guarantee a settlement by obtaining an informal advisory role in Hong Kong after 1997 and by influencing the shape of the so-called miniconstitution Beijing has proposed for Hong Kong—to ensure that Beijing cannot easily circumvent the city's autonomy.<sup>1</sup> [ ]

<sup>1</sup> The British believe that wrapping up a settlement in an internationally recognized treaty should be a fundamental guarantee for an agreement. Other guarantees the British hope to arrange include: an independent judiciary, a locally elected legislature and executive, and a substantial British involvement in Hong Kong after 1997. [ ]

Disagreement over these or other issues, therefore, could lead to a prolonged stalemate in the talks or even their collapse. Below we examine six different ways the talks could go and what the likely consequences would be in each case. [ ]

#### Scenario 1—An Interim Solution

*The two sides handle the Chinese deadline for the talks of September 1984 by issuing an innocuous joint statement during that month. A preliminary agreement on Hong Kong's future is then concluded by mid-1985. Under the agreement, which is only a statement of principles, the United Kingdom will relinquish sovereignty and administrative control over the city in 1997. In the meantime, the United Kingdom will retain administrative control, but has agreed to turn increasing responsibility over to local Chinese. After 1997, local Chinese will administer Hong Kong for Beijing with the assistance of some expatriate British officials, who will be involved primarily in the financial and legal sectors.* [ ]

*This accord guarantees the right of Hong Kong citizens to travel abroad and to maintain their existing lifestyles. It also stipulates that the Hong Kong dollar will remain an independent currency and that Hong Kong will retain its independent status in international organizations, such as the General Agreement on Tariffs and Trade (GATT).* [ ]

*Beijing and London announce the establishment of working groups of technical experts to negotiate the details of a final settlement. Only then will an agreement be submitted to the British Parliament for ratification.* [ ]

**Consequences.** Such an accord probably would be initially welcomed by all sides. It would allow both Beijing and London to claim progress toward a satisfactory resolution of the problem. Moreover, it would buy more time to sort out the most complex and still contentious issues—such as the role and authority of British expatriates. Prime Minister Thatcher would particularly welcome the opportunity to report progress to Parliament. An interim agreement—as long as

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it was solid enough—probably would also help calm local fears and perhaps even help to stimulate economic recovery in some depressed sectors of the local economy such as the real estate market. Probably only Taiwan would be strongly critical of the accord. Beijing would exploit the accord to increase pressure on Taipei to reach its own settlement with Beijing.

Beijing would herald an agreement as paving the way for China's ultimate recovery of Hong Kong—glossing over the remaining difficulties. It would give the Chinese an opportunity to capitalize on the initial positive reaction in Hong Kong to win over at least some residents still skeptical of China's promises. Beijing in fact has already begun soliciting the views of some of its staunchest critics in the colony. The US Consulate in Hong Kong reports, for example, that Beijing has retained a pro-British law firm to draw up a draft miniconstitution.

Chinese leaders would also try to use the accord to demonstrate to Taiwan how reasonable Beijing could be in reunification talks. Although the government in Taipei probably would remain skeptical and unresponsive, we believe the Chinese approach to further talks with London probably would continue to be influenced by their desire to entice Taipei into a dialogue.

British leaders of course would be relieved to have avoided serious strains in Sino-British relations and calamity in Hong Kong. Having conceded sovereignty and administrative control in principle, they also would hope to influence the Chinese to handle the remaining negotiations—even on the most difficult and contentious issues—with a minimum of acrimony to avoid the unsettling effect the earlier talks had had on the economy and security climate in Hong Kong. We believe London would still be able to exert some leverage because of its ability to grant legitimacy to a transfer of authority, instill confidence in a final settlement, and cooperate with the Chinese during the transition.

We believe that the initial local reaction in Hong Kong to such an interim agreement would be largely favorable. The people of Hong Kong probably would feel somewhat relieved that progress had been made

that clarified their future. With most residents already resigned to a Chinese takeover, they would view the agreement as the best solution for a bad situation. Much of their sense of relief would be based on the continued British presence, which many in the city view as necessary to prevent Beijing from meddling in Hong Kong's affairs.

Some residents of Hong Kong would also welcome the opportunity to play a larger role in government. Under this type of agreement, the British would accelerate the promotion of local Chinese—presumably favorably disposed to the United Kingdom—into more senior positions. Pressures for greater democracy could also result in the introduction of elections for some seats on Hong Kong's Legislative and Executive Councils (the Governor now appoints all members).

The increased certainty about Hong Kong's future status probably would benefit the local economy, thus serving both Chinese and British economic interests. It might boost private investment in the colony, earlier depressed by the world recession and uncertainty over the negotiations. The local stock market index might significantly improve, at least initially—but both the Hong Kong dollar and the stock market would remain subject to Hong Kong's traditionally volatile business cycles. An interim agreement could also somewhat improve Hong Kong's shaky real estate market, particularly if it explained how property leases extending beyond 1997 would be handled.

Still, some of the approximately 300,000 Hong Kong residents who currently hold foreign passports or visas would choose to emigrate, mainly to the United States, Canada, Australia, or the United Kingdom. Because the United States allows only 600 Hong Kong residents a year to immigrate, there is already a backlog of some 18,000 residents holding US immigrant visas.

US commercial interests would benefit from the improved economic climate. US firms could play a role in large projects the British or Chinese would be

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undertaking, such as the Daya nuclear plant or possibly infrastructure improvements, such as a new airport. The colony's close trading relationship with the United States would be largely unaffected.

### Scenario 2—The Talks Drag On

*The Sino-British talks on Hong Kong's future enter their fourth year without reaching an agreement. The British still refuse to concede sovereignty formally until they reach a satisfactory agreement on Hong Kong's administration both before and after 1997. In September 1984 the Chinese make a unilateral statement on Hong Kong's future, delaying the establishment of working groups that are only now beginning to address such matters as the structure of Hong Kong's administrative and legal systems. Both sides decide to seek a comprehensive settlement rather than an interim agreement. To prevent economic problems from getting out of hand in the colony, both sides pledge to help stabilize the colony's economy. Capital investments are still down and the property market remains weak. Only the export industries are doing well.*

**Consequences.** We believe Hong Kong's economic problems would slowly worsen if the talks dragged on:

- Investment would decline, causing a net capital outflow. Hong Kong's Financial Secretary, John Bremridge, recently expressed concern over the impact the present decline in investment could have over the longer run, if not reversed in the next year.
- Major banks or corporate failures, such as last year's collapse of the Carrian conglomerate, could increase.
- The local property market would remain stagnant.
- A speculative run on the Hong Kong dollar could easily occur. This would be accelerated by traders, investors, and ordinary residents switching their accounts into US dollars and transferring some of their funds abroad. Both Beijing and London would incur financial losses.
- Emigration would pick up. More families would try to get one member abroad to arrange the emigration of the rest if the situation deteriorated. Hong Kong residents probably would lobby the United States to allow more immigration.

Unable to reach an agreement with London, Beijing probably would accelerate its efforts in the colony to promote its plan and increase its influence. Beijing's press outlets would probably issue a steady stream of propaganda that contrasted China's conciliatory approach with Britain's rigidity. China would certainly invite more influential locals to Beijing to express their views. The Chinese might also offer financial support to troubled companies. If too heavyhanded, these actions could further sour the atmosphere in Hong Kong and harm the economy.

The British would find Hong Kong an increasingly difficult problem to handle if the talks continued on without an agreement. We believe Prime Minister Thatcher would attempt to refrain from publicly rebuking Chinese pronouncements on Hong Kong's future. But if Beijing's comments became too troublesome, Thatcher and other British officials might be provoked into responding in Parliament or the press, which could damage UK-Chinese relations and cause concern in Hong Kong.

Prolonged talks would expose Thatcher to greater domestic pressure to get the talks moving in order to reassure both Hong Kong's citizens and the financial community. Much of this pressure would come from a minority of members of Parliament in both the Conservative and Labor Parties who take an active interest in Hong Kong affairs or who favor close ties with Beijing. Moderates would press the government to make concessions to Beijing. Others (notably the Tory right, Thatcher's base of support) would call on the Prime Minister to adopt an unyielding stance as the only way to tie down Beijing and make the Chinese "see reason."

Within Hong Kong, political ferment would increase. Local pressure groups such as the Hong Kong Observers or Meeting Point (small groups made up mainly of professionals) would grow as they tried to promote and protect their interests. These groups are trying to promote a public debate over Hong Kong's future.

Differences within Hong Kong's Executive and Legislative Councils could also complicate the British position. Both councils are made up of British and

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local members appointed by the Governor. The Executive Council (which includes the colony's senior leaders) has been the only group in the colony formally consulted on the talks. The British are already worried that several factions in the Executive Council will air their differences in public. According to local officials, some hardline members of the Council believe the British should push the Chinese, and even threaten to break off the negotiations, if Beijing remains unyielding. Others such as Lydia Dunn, an ethnic Chinese member of the Council, have publicly called for elections and termed a British presence in Hong Kong after 1997 as not essential. [ ]

### Scenario 3—The Talks Break Down

*China's unilateral announcement of its plans for Hong Kong in the fall of 1984 causes confidence to plummet in the colony. By mid-1985 a surface calm returns. There is little chance that the unproductive Sino-British talks—which broke off in early 1985—will resume soon. London is trying to "tough it out" by holding firm to its negotiating position. The UK is also trying to maintain "business as usual" but has imposed greater financial controls to impede capital flight. Beijing, meanwhile, is trying to gain the upper hand by increasing investments and seeking popular support for its miniconstitution.* [ ]

*Both sides scale back their propaganda war to restore calm and help the economy recover. The people of Hong Kong learn to live with this uncertainty, although human and capital flight increase. The property and financial markets also remain weak.* [ ]

**Consequences.** A breakdown in the talks would impose a substantial economic burden on Beijing. In addition to having to spend foreign exchange to bolster the Hong Kong dollar, Beijing probably would feel compelled to invest more in the colony to help offset the loss of local and foreign investments caused by the growing uncertainty over Hong Kong's future. [ ]

China, in fact, has already begun making such investments in order to demonstrate its commitment to Hong Kong's future. Last January, China's Everbright Corporation bought a 1,200-apartment housing complex for \$128 million<sup>2</sup>—one of the colony's larger

real estate transactions in recent years. Beijing's China Resources Company recently announced it will open a supermarket chain in the colony. The Bank of China also is expanding its business in Hong Kong. [ ]

The colony's economic problems probably would also negatively affect bilateral trade between China and Hong Kong, but only to a limited extent. Much of China's exports to the colony—which amounted to \$5.5 billion in 1983—is in foodstuff for the local market and goods that Hong Kong reexports. Hong Kong, in fact, relies on China for half of its food imports. The cutback of Hong Kong investment in the special economic zones would also cause problems for Beijing. [ ]

More important, these economic problems probably would force Beijing to reexamine its negotiating strategy. Fearing a collapse of the Hong Kong economy, some Chinese leaders might advocate greater flexibility. Others, influenced by strong nationalistic feelings, however, probably would advocate maintaining a hard line and perhaps even urge threatening the use of force to compel London to accommodate Chinese demands. [ ]

An obvious chill would occur in Sino-British relations. Under some circumstances, this could affect China's relations with some of the Western states including the United States. If US firms began pulling out of Hong Kong, for example, Beijing might suspect the United States of collaborating with the British to force Beijing to moderate its negotiating stance. [ ]

Australia and Japan, which have close ties with both the United Kingdom and China, would also be placed in a difficult position. Not wishing to harm their ties with either country or within the colony, these countries would probably be reluctant to become involved in the dispute. The Japanese have already sidestepped a British request to help "educate" the Chinese on the importance of maintaining a British link to Hong Kong after 1997. [ ]

<sup>2</sup> All dollar figures in this paper are given in US dollars. [ ]

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Many civil servants probably would seek a special exemption from British immigration restrictions. Recruitment would become more difficult. And the British would increasingly have to worry about the loyalty of their Chinese employees in sensitive positions. The temptation for younger ethnic Chinese policemen or employees of the colony's intelligence services to switch their loyalties to Beijing is certain to grow in any event. The police lost an important incentive to remain loyal last year when their efforts to obtain assurances that they could immigrate to the United Kingdom were rebuffed. China's intelligence service could easily exploit such a situation to penetrate the Hong Kong police and intelligence services.

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A breakdown in the negotiations might, in our judgment, also prompt London to seek Washington's help in convincing Beijing to seek a compromise. In January the British asked the United States in effect to lobby the Chinese during Premier Zhao Ziyang's visit to Washington not to take precipitate action that could bring about a collapse in Hong Kong.

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Anxiety in Hong Kong, meanwhile, would cause human and capital flight to accelerate. That probably would force the British to restrict the amount of funds individuals could transfer out of the colony. Exchange controls could destroy Hong Kong's prospects for remaining the financial center of Asia. The colony has prospered because, unlike other Asian markets, Hong Kong guarantees the privacy of transactions and imposes few restrictions on financial matters.

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Hong Kong's own government would also be placed under increasing financial strain. The continued economic problems would reduce the colony's revenue base, causing the budget deficit to grow. The government ran a \$410 million deficit in 1983 in part because of the slumping property market. The British, who normally do not allow the colony to run a deficit, have already raised local taxes and fees to offset last year's losses. The 1983 deficit reduced the colony's reserve account from \$1.5 billion to \$1.1 billion. With such limited reserves, the colony cannot afford to run further deficits for long.

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A breakdown in the talks would also cause serious problems in the local civil service. The colony's 170,000 civil servants have already been hurt by the declining value of the local dollar. Many are worried about their pensions, prompting the Hong Kong Government to deny rumors that it intends to replace pensionable employment with short-term contracts.

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#### Scenario 4—The British Cave In

*Beijing places London under intense pressure to concede, even making veiled threats of military intervention. After exhaustive and fruitless efforts at compromise, the British Government decides to acquiesce in China's main demands. Under the agreement reached in late 1985, the British will gradually begin turning over administrative control of Hong Kong to local Chinese approved by Beijing. British forces will be replaced in 1990 by a locally raised militia. China has pledged not to change Hong Kong's political or economic systems for 50 years after it formally regains sovereignty in 1997.*

**Consequences.** British leaders would attempt to mask the extent of their surrender. Such a coverup would not work for long and would almost certainly badly damage the government's credibility. As long as it held a comfortable majority in Parliament, the government would be in no danger of falling, but its standing with British voters and its allies would suffer.

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<sup>3</sup> There is little reason now for London to acquiesce in Chinese demands. Indeed, Prime Minister Thatcher would be loath to surrender her "Iron Lady" reputation or her party's traditional claim as a stalwart defender of British interests abroad. Even a leftwing Labor government, unsympathetic to business interests and anxious to reduce commitments overseas, would not want to face charges of creating a massive refugee problem that Britain would be expected to help solve. Moreover, no British Government, particularly a Tory one, would willingly expose itself to rightwing charges of abandoning commitments to a long-held dependency—setting a dangerous precedent for such areas as the Falklands and Gibraltar.

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Chinese leaders, on the other hand, would presumably be delighted by the opportunity to dictate the terms of their takeover—especially at first. They almost certainly would seek to enlist British cooperation for a smooth transition and to help calm local fears. But they would also seek to quickly extend their influence in the colony by handpicking local Chinese to assume administrative responsibility. The head of the Hong Kong Xinhua office, as the senior representative of China on the scene, would become virtually the de facto governor. [ ]

Beijing, however, could easily mishandle the transition arrangements. China's lack of sensitivity toward the concerns of Hong Kong's residents has periodically caused unrest and dissatisfaction in the colony. In 1982 Beijing's credibility sank after its press outlets tried to compare China's ability to manage Hong Kong with the "success" of Shanghai. This statement provoked a strong reaction among many businessmen in the colony who have bitter memories of the Communist takeover in Shanghai following the 1949 revolution. The praise Xu Jiatao, Xinhua's chief in the colony, gave last August to Hong Kong's Walled City during a visit to that slum also evoked strong negative emotions over the way China might administer the colony. This enclave in Kowloon was exempted from British control in the 1898 treaty establishing the New Territories and is one of Hong Kong's most run-down neighborhoods. [ ]

Even without such indiscretions, human and capital flight from the colony would dramatically increase. The exodus would include many of Hong Kong's professional and business elite. The former chairman of Hong Kong's Bar Association predicted last August that a majority of the colony's lawyers and judges would leave the territory if the independence of the judiciary was compromised. The president of Hong Kong's Medical Association has also predicted that at least 80 percent of the colony's 5,000 doctors would try to leave if the outcome of the talks were unfavorable. A poll taken in November indicated that three out of 10 young managers in Hong Kong planned to emigrate in the next five years. [ ]

The outflow of capital would seriously affect Hong Kong's economy. The colony's ability to remain a major exporter would be stifled because funds for new

plants and equipment would dry up. At least several of the colony's banks and companies would probably fail as a result. More firms would either begin to leave the colony or diversify their interests abroad. Inflation and unemployment probably would rise quickly, making the colony more susceptible to social unrest. [ ]

These economic disruptions would have negative consequences for China. In addition to having to spend more on propping up Hong Kong's economy, Beijing's substantial entrepot trade through the colony would be harmed by the departure of local businessmen and their firms. The departure of much of Hong Kong's entrepreneurial class would also seriously affect China's foreign investment program. The four special economic zones in Guangdong and Fujian Provinces rely heavily on Hong Kong investors. [ ]

The United States and other countries would both benefit and suffer as a result of the flight. To the extent that capital and Hong Kong's elite seek refuge in these countries, they would be welcomed. Taiwan, Singapore, and Thailand have already revised their laws to encourage capital from Hong Kong to flow into their countries. Singapore especially would benefit if international corporations moved their regional headquarters from Hong Kong. On the negative side, US, Japanese, and other foreign companies with substantial investments in Hong Kong would suffer losses. Even though few US firms have large fixed assets in the colony, the collapse of several major local companies or banks could certainly harm the interests of several large US banks operating in the colony. [ ]

A British cave-in would almost certainly reinforce Taiwan's recalcitrance toward Beijing's reunification efforts. Taiwan could easily point to the economic and social problems in the colony resulting from an anticipated Chinese takeover. Taiwanese investors could begin pulling out their relatively modest investments in the colony, estimated to be worth \$14 million. Taipei would probably welcome Hong Kong investors and professionals who wish to resettle on the island, but would be reluctant to accept a larger exodus of Hong Kong residents. [ ]

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**Scenario 5—The British Walk Out**

*China's leadership becomes more leftist, and its demands for British concessions increase. Simultaneously, the Chinese press the people of Hong Kong to work with them in drawing up a miniconstitution as the basis for the self-administered, special administrative region. The Chinese are also expanding the number of their own personnel in Hong Kong. As a result, the British believe the Chinese are no longer bargaining in good faith and are only going through the motions while they prepare to take over on their own terms—perhaps even before 1997. Given their difficult position, the British have decided that the only way they can gain any leverage with the Chinese is to declare their intention to pull out of Hong Kong unilaterally within two years. The Prime Minister believes that even if this ploy does not force the Chinese to be more cooperative, it is better to pull out than preside over China's takeover. After the British announce their plan in November 1985 to begin a phased withdrawal, the Chinese rebuke the British publicly for their unwillingness to work with China. The Chinese, however, privately ask the British to extend their withdrawal period to provide a smooth transition.*

**Consequences.** Such a high-stakes gamble could easily boomerang on all concerned. Unless the Chinese quickly softened their negotiating demands and the British agreed to resume negotiations, London's announced plans to withdraw would probably set off the kind of public panic in Hong Kong both London and Beijing have sought to avoid.

For London, such a ploy would risk:

- Precipitating a massive exodus of refugees that the British public and Hong Kong's neighbors would not welcome.
- Damaging Britain's economic interests both in Hong Kong and with China.
- Provoking strong attacks from the right wing of the Conservative Party as ill conceived. Many conservatives recall the disastrous effects similar tactics had in 1947 when the Attlee government tried to force the pace of Indian intercommunal negotiations by publicly announcing its intention to end British rule in a short period. The subsequent violence and partition of the subcontinent make this a precedent few British politicians want to repeat.

- Damaging Britain's prestige.
- Destroying London's bargaining position with Beijing.
- Humiliation if Beijing called London's bluff.

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Beijing would be ill prepared to take over Hong Kong in so short a time, even with British cooperation. Its most difficult challenge would be reassuring the local population and maintaining Hong Kong security. Many Hong Kong residents fled from Chinese Communist rule or are the children of such refugees. Because most have few attractive alternatives, the resulting frustrations could spark sporadic violence, especially against foreigners. To ease this tension, Beijing would probably reiterate its previous public promise to allow Hong Kong's residents to travel abroad and even emigrate.

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The absence of a lengthy transition period would cause unique administrative problems for Beijing:

- It would have to replace many of the departing expatriate and local administrators with inexperienced officials. Beijing probably recognizes that bringing in too many personnel from China would increase local concerns.
- A new organic law for Hong Kong would have to be drafted using local help, due to China's limited legal expertise.
- Hong Kong's existing treaties and membership in international organizations would have to be renegotiated quickly, including the city's vital textile agreements.

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Human and capital flight again would create a familiar litany of economic problems that would also affect China's own economy, causing a drain on Beijing reserves and the loss of valuable investment capital and Hong Kong business expertise.

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**Scenario 6—Hong Kong Collapses**

*After the talks break off in January 1985, the atmosphere in Hong Kong begins to worsen. Beijing intensifies its media campaign to win popular support and to intimidate the British—provoking a serious economic crisis. After the Hong Kong dollar drops below the 20-to-1 US dollar rate and the stock market collapses, panic sets in and capital and human flight accelerates to record proportions in March. The rioting that then breaks out forces the British to fly in reinforcements to restore order. Beijing threatens to send in troops but does not do so. If further anarchy occurs in Hong Kong, however, Chinese troops will probably enter the city “to assist” the British in ending the violence.* [ ]

**Consequences.** The outbreak of widespread disorders would be a disaster for all concerned. In the short run, we think the Thatcher government would oppose Chinese intervention and could count on the full support of Parliament and the British public for whatever steps it chose to take to restore order. Once order was restored, however, the government probably would face an official inquest and tough questioning in Parliament about its handling of negotiations.

[ ]

Government critics probably would be particularly unhappy over the high costs of restoring stability. Not only would London have to bear the burden of maintaining expeditionary forces in Hong Kong, but it probably would have to provide emergency funds to help keep vital services running. The British have admitted they have contingency plans to use the resources of the Bank of England to keep the Hong Kong economy from collapse in just such an emergency. London now contributes only about \$50 million annually to help pay a quarter of the costs of stationing 12,000 troops in the colony, including a regiment of Scots Guards and four battalions of Gurkhas. Hong Kong's 23,000-member police force and other public services in the colony are paid for out of local revenues. [ ]

To help restore public confidence in Hong Kong, the British probably would appeal to other states for economic, humanitarian, and diplomatic assistance. London probably would prevail on Washington, in particular, to try to induce Beijing to adopt a more conciliatory posture to facilitate a settlement. [ ]

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**Indicators of Potential Instability in Hong Kong**

- Capital Flight
- Sharp Fall in Value for the Hong Kong Dollar
- Increased Interest Rates <sup>a</sup>
- Serious Decline in the Local Stock Market Index
- Weak Property Market <sup>a</sup>
- Higher Inflation <sup>a</sup>
- Growing Unemployment <sup>a</sup>
- Increasing Use of US Dollars in Local Transactions
- Increase in Emigration
  - Managers and Professionals Leaving Colony
  - More Students and Residents Abroad not Returning to Hong Kong
  - More Attempts To Leave Hong Kong Illegally
- Substantial Budget Deficits <sup>a</sup>
- Violence, Especially Against Foreigners
- Increased Propaganda Exchanges
- Greater Local Political Activism
- Major Domestic and Foreign Companies Moving Offices Out of Colony [ ]

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<sup>a</sup> Not necessarily indications of instability, but common to most economic cycles.

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Indeed, London might try to capitalize on the disorders to promote a compromise accord with Beijing. To prepare public opinion in Hong Kong, British officials might praise Chinese restraint during the crisis to try to engender confidence in Beijing's promises to respect Hong Kong's special status. At the same time they probably would try to play on Chinese concerns over further disorders to press for a speedy conclusion to negotiations. Given the costs to the British, we believe London would also be inclined to adopt a more flexible approach to a settlement. [ ]

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We believe the Chinese would be extremely reluctant to send in troops during the crisis unless London asked, or they concluded the British could not restore order on their own. Otherwise, they would fear such a move might inflame anti-Beijing sentiment in Hong Kong, provoking increased violence, triggering increased human and capital flight, provoking strong

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Western criticism, and giving Taiwan added ammunition for rejecting any dialogue with the mainland.

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The Chinese would try to limit the damage to their economic interests. But the costs in terms of the loss of skilled and professional people, property, and future business prospects would be incalculable. Legal and illegal emigration could soar, presenting neighboring countries and Western states with a humanitarian problem comparable to the Vietnamese "boat people." However, the British might try to stem that tide to avoid damaging its relations with these countries.

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Whether the Chinese would be willing to reassess their negotiating strategy and adopt a more flexible position is less certain. Calculating the worst was already over, they could perceive the British as vulnerable and press harder for the acceptance of their terms. They might even blame British intransigence for the breakdown in public order.

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If the worst happened and Beijing retook Hong Kong militarily, the British would offer little resistance and would activate contingency plans already in place to quickly exit the colony. Chinese forces would have to be considerably beefed up from their current alltime low level opposite Hong Kong prior to a takeover. According to one report in the Hong Kong press, Beijing believes the PLA could take control of Hong Kong within nine hours at night and 11 hours during the daytime.

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